

Central Intelligence Agency



Washington, D. C. 20505

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DIRECTORATE OF INTELLIGENCE

22 August 1985

China: Hainan Auto Scandal--Limiting the Damage [redacted]

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Summary

The 31 July announcement that Hainan Island officials were being sacked for large-scale profiteering capped months of internal wrangling over how to handle the case. We believe conservative elements in the leadership demanded that it be publicized as an example of a breach of party discipline, but both reform and conservative leaders are anxious to avoid further damage to the party's image and may share concerns that national leaders--or their children--will be implicated if the case is not contained. Central media have also carefully limited references to the extensive military involvement in importing and transporting the illegal goods. As it stands, the scandal is a major embarrassment to Deng Xiaoping and will certainly be used as ammunition against the reform program during the planned party conference in September. We believe China remains committed to the open-door policy, although Beijing will probably rein in local foreign trade authority to prevent future Hainan Island cases. [redacted]

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On 31 July Chinese central media began carrying details of a massive case of profiteering in imported goods by officials on the southern Chinese island of Hainan. Authorities on the island reportedly arranged to import 89,000 motor vehicles, 2.8 million televisions, 250,000 video recorders, and 122,000 motorcycles for resale to other parts of China at inflated prices. Hainan officials also engaged in black-market

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This memorandum was prepared by [redacted] China Division, Office of East Asian Analysis, and [redacted] Asia Near East Division, Office of Central Reference. Information available as of 22 August 1985 was used in its preparation. Comments and queries are welcome and may be directed to Chief, Domestic Issues, China Division, OEA, [redacted] or Chief, China Branch, OCR/ANE, on [redacted]

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currency trading and obtained illegal loans to finance the operation. The head of the island's government and several other local leaders have been fired, and 143 additional cases are reported to be under investigation. []

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Hainan's development as a center of profiteering is the result of special trade concessions, including exemption from some import duties, which Beijing granted the island in 1983 in order to promote its economic growth. In a March 1984 interview, Lei Yu, the recently fired head of the island's government, claimed that "The state agreed to support Hainan's rapid development but is unable to undertake every need. So they said, as we cannot give you all the money needed, we give you the policies so that you are allowed to act in ways other local administrations are not yet allowed." []

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Beijing obviously never intended that Hainan engage in extensive profiteering in goods that were unrelated to the island's development. Island officials found, however, that pent-up consumer demand, rising incomes, and insufficient Chinese production had created a seller's market for imported goods throughout China, which they and their organizations were able to exploit. Island officials expanded import arrangements in mid-1984, and, according to central media accounts, began methodically taking advantage of loopholes in regulations. For example, cars were driven for several days on the island and then resold as "used," or fines for illegally importing goods were simply paid, and the amount of the fine tacked on to the selling price. The traffic in imports grew to involve nearly all departments of the Hainan regional government, military organizations, and hundreds of other units, including enterprises, schools, and even kindergartens. Beijing has admitted that mixed signals were sent to Hainan through 1984 regarding the profiteering, which local officials interpreted in their favor to continue the trafficking. []

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By early 1985 profiteering in southern China had become so extensive that it contributed to a drop in China's foreign exchange reserves and may have affected the currency exchange rate. Much of the traffic was in consumer goods that contributed little to China's development. Beijing's intensifying campaign to force officials and party members to get out of commercial trade also directed attention at the extensive official involvement in trading companies on Hainan and in other southern economic zones. []

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Beijing reined in most of the illegal trade in March. Thousands of motor vehicles were reportedly confiscated while being shipped north, and vehicles on the island itself were impounded. A Hong Kong press report in May stated that some 50,000 autos were handed over to central authorities. In early May Hainan Party Secretary Yao Wenxu publicly admitted that island authorities "made mistakes in the matter of imported motor vehicles" and acknowledged that the Central Discipline Inspection Commission (CDIC) had intervened to correct the situation. [REDACTED]

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Containing the Scandal

Having cut off the trade in imported consumer goods, Chinese leaders spent months wrangling over how to handle the case. We believe that conservatives demanded that a scapegoat be found as part of their efforts to reestablish discipline in the party by singling out leading cadres who had violated central directives. The extent of the Hainan auto trade was well known throughout China, and Beijing's "get tough" policy toward official corruption would have been seriously compromised if no action were taken. [REDACTED]

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We also believe conservatives were anxious to press the case as an example of placing local interests ahead of national interests. In the past, some officials engaging in profiteering were exonerated if they did not personally profit from the trade but did it for the sake of their unit or locality. The handling of the Hainan case, in which officials who did not profit from the trafficking in imports have been held responsible and sacked, illustrates a tougher central approach. [REDACTED]

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Although conservatives probably demanded that the case be publicized, we believe that both conservatives and reformers originally wished to limit the scandal to Hainan Island. The result was a CDIC circular dated 31 July, which carefully fixed responsibility for the scandal on several island officials. By using these officials as scapegoats, Beijing is attempting to protect the party's image and hopes to control the fallout in a number of potentially sensitive areas:

*Evidence indicates that southern military units were extensively involved in profiteering activities and that military equipment was used to transport goods from Hainan to other regions of China. [REDACTED]

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[REDACTED] However, we [REDACTED]

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believe this represents only a fraction of the overall military participation in the case. Beijing almost certainly wants to keep the military from being implicated further in the scandal, particularly in light of difficulties already encountered in carrying out PLA force reductions.

°The CDIC circular acknowledges that organizations and officials outside of Hainan, including some at the central level, participated in the profiteering, but Beijing recognizes the danger of allowing such groups and individuals to be publicly implicated in the scandal. In particular, Beijing appears to have coordinated the breaking of the case with the appointment of a new leadership for Guangdong Province, taking care that Guangdong leaders are insulated from the scandal's fallout.

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°Beijing is clearly anxious to deflect speculation that Hainan authorities may have been caught in an ambiguous situation in carrying out reforms. Accounts of the scandal are designed to disprove the contention of Hainan officials that they acted in accord with the reforms and properly used the special authority that had been granted to the island. For example, Chinese accounts of the case stress the large scale of the operation, citing the figure of 89,000 motor vehicles, although the reports go on to admit that only 10,000 were actually resold for excessive profit on the mainland. Accounts have also detailed methods Hainan officials used to exploit loopholes in regulations that forbid the import and resale scheme.

°The Hainan scandal represents another blow to China's "opening to the outside" policy, following on the heels of Deng Xiaoping's statement that Shenzhen is an "experiment" that might fail. Since the scandal broke, Beijing has tried to assuage foreign concerns over China's reliability as a business partner by repeatedly stating that the "open-door policy" will continue and should be speeded up. These efforts could be undermined by a spreading foreign trade scandal.

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Prospects and Consequences

Details of the Hainan scandal are still unfolding. The initial CDIC circular states that 143 individual cases are still under investigation, although it does not specify whether these investigations are limited to the island. It is probable that some individuals who directly profited from the resale of imported goods will face prosecution. The scope of the case has spread to include enterprises in the Shenzhen Special Economic Zone, but leading officials of the zone have not been publicly implicated. In addition, some military units have been named in the scandal. It appears, however, that leading officials facing punishment in the case will be limited to the Hainan leaders already sacked. Guangdong Party Secretary Lin Ruo recently stated, "This time only three comrades have been dealt with, and I deem it appropriate." [redacted]

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We believe that Beijing's containment efforts will probably succeed, but successful management of the case depends to some extent on the willingness of Hainan authorities to accept blame. If these individuals choose to make their side of the case public through channels such as the Hong Kong press, Beijing may be forced to assign some blame to higher level officials. Zealous prosecution of the case by lower level public security units could also force Beijing to lengthen the list of publicly implicated persons and organizations. [redacted]

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The Hainan case is a major embarrassment to the reform program of Deng Xiaoping and his proteges, who advocated the establishment of the economic zones in south China as an element of the "opening to the outside." Conservative leaders, including Chen Yun, believe the Hainan case justifies their warnings that reformers have been moving too fast and that the reforms have been eroding local officials' responsiveness to central control. They will certainly point to the Hainan case as an example of reform problems during the planned September party conference. [redacted]

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Reformers have shown a degree of flexibility in acknowledging conservative criticisms. The developing scandal on Hainan was probably partly behind Deng's moderate tone toward the economic zones this spring, including his late June reference to Shenzhen as an "experiment" that might fail. Although conservatives have strengthened their hand as a result of reform

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problems such as the Hainan scandal, we believe reformers' flexibility and Deng Xiaoping's prestige will keep the reforms broadly on course. [REDACTED]

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In our opinion, Beijing's policy of opening to the outside--of encouraging foreign trade and investment as a part of China's modernization drive--will continue, albeit in a modified form. The Hainan case and other problems with China's economic zones have contributed to Beijing's recentralization of foreign trade authority and restrictions on the use of foreign exchange by localities. We believe that Beijing, to prevent another case like Hainan, will attempt to develop clearer foreign trade guidelines before again loosening controls. Beijing will probably also emphasize the use of foreign trade to develop existing industrial centers, such as Shanghai. Since the scandal broke, the Shanghai press has pointedly discussed the problems of building up "new" economic zones, calling them a much less efficient investment than "established" cities such as Shanghai. Beijing will also attempt to guide foreign trade to fit China's development needs in areas such as energy, transportation, and mining. [REDACTED]

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